INDEX

CITATIONS

766-948—65——1

Cases—Continued

Statutes and Regulations—Continued

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 486

W. BALMER DIXON, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (R. 4–15) is reported at 224 F. Supp. 358. The opinion of the court of apepals (R. 44–49) is reported at 333 F. 2d 1016.

JURISDICTION

The judgment of the court of appeals was entered on June 19, 1964 (R. 50). The petition for writ of certiorari was filed on September 11, 1964, and was granted on December 14, 1964 (R. 51). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the excess of the face amount of a note over the amount of money for which it was issued

represents income which an accrual-basis lender must accrue ratably as it is earned.

2. Whether the Commissioner was estopped to challenge the taxpayers' treatment of their gain from the sale of notes issued at a discount as capital gain because of a prior acquiescence in another case.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and regulations are set out in the Appendix to our brief in the companion case, *United States* v. *Midland-Ross Corp.*, No. 628.

STATEMENT

Petitioners are partners in the investment firm of Carl M. Loeb, Rhoades & Company. At various times during the taxable year 1952, the partnership purchased for its own account 33 short-term, non-interest bearing notes, either directly from the obligor corporation, or through agents or dealers. The notes bore maturity dates ranging from 190 to 272 days from the date of issue, and all were issued at discounts varying between 2⅜% and 3¾% of the face value. The total face amount of the notes was $43,050,000 and the amount for which they were issued was $42,222,357. Upon purchase the notes were pledged as collateral to secure bank loans in the full face amount of the notes (R. 28–29, 32).

During 1952, the partnership sold 20 of the notes, after holding them for more than six months, at a profit of $494,528. In the same year, it paid $624,000 in interest on the bank loans used to finance the purchase of the notes. The remaining 13 notes were not disposed of until the following year (R. 29).

In the partnership return for 1952, the $494,528 gain on the sale of the 20 notes was reported as long-term capital gain; no income was accrued on account of the 13 notes remaining on hand; and the $624,060 interest paid on the bank loans was deducted as an ordinary deduction. Petitioners reported their distributive shares of the partnership income in the same manner. The Commissioner determined that the excess of the face amount of the notes over the amount of money for which they were issued represented interest accruing over the term of the notes. Since the partnership was on the accrual basis, the interest accruing on all 33 of the notes during the period they were held by the partnership was determined to be includible in partnership income and hence in petitioners' distributive shares.[1] Petitioners paid the resulting deficiencies and in due course brought this suit for refund (R. 46). Both the district court (R. 4-15) and the court of appeals (R. 44-49) upheld the Commissioner's determination and denied the refunds.

ARGUMENT

INTRODUCTION AND SUMMARY

The transactions involved in this case are virtually identical to those involved in the companion case, *United States* v. *Midland-Ross Corp.*, No. 628, and the

[1] As the court of appeals noted (R. 47), "no question has been raised as to the propriety of taxing the individual partners for notes held by the partnership, and the taxpayers have conceded that if the discount *did* represent ordinary income, that income was realized upon each of the thirty-three notes held, and was not dependent upon a sale".

basic issue is the same. We showed in our brief in that case that the amount to be paid on maturity of a note in excess of the amount for which it was issued is equally "interest" paid for the use of money—and must be so taxed—whether it is labelled as such or is given no name. No purpose would be served by repeating that argument here, and we respectfully refer the Court to our brief in *Midland-Ross* for our principal argument on the issue common to the two cases. Our brief in this case will be confined (1) to answering petitioners' alternative argument that the Commissioner was estopped to assert the tax involved in this case because of his acquiescence in *Caulkins* v. *Commissioner* (an issue not raised in *Midland-Ross*) and (2) to responding to particular arguments made by respondents which warrant special comment.

With respect to the estoppel issue, we argue, first, that an acquiescence in an erroneous decision cannot bar the United States from collecting a tax otherwise lawfully due, and that petitioner cannot claim to have been misled in this regard, since each Cumulative Bulletin carries a prominent warning that rulings and acquiescences do not have any binding effect. We further show that, even if the Commissioner were committed to follow any decision in which he had acquiesced, the *Caulkins* decision in no event supports the treatment claimed by petitioners.

In the second part of our brief, we respond to petitioners' contentions based upon (a) the legislative history of the Act of June 17, 1929 (exempting interest on Treasury bills); (b) the 1938 report of a

subcommittee of the House Ways and Means Committee; (c) the alleged redundancy of certain special statutory provisions if bond discount were generally treated as interest; and (d) the treatment of bond premiums.

I

THE COMMISSIONER'S ACQUIESCENCE IN THE CAULKINS DECISION HAD NO LEGAL FORCE AND IS DISTINGUISHABLE IN ANY EVENT

Petitioners contend that the Commissioner was estopped to challenge their treatment of the note because he had previously announced,[2] and only later withdrew,[3] his "acquiescence" in *Caulkins* v. *Commissioner,* 1 T.C. 656, affirmed, 144 F. 2d 482 (C.A. 6). The argument is insubstantial for two reasons: (1) an acquiescence has no binding force; and (2) *Caulkins* is distinguishable in any event.

1. The power to prescribe how transactions will be taxed lies with Congress, not the Commissioner, and his rulings can have only such force as Congress chooses to give them. There being no statute giving acquiescences the force of law, an acquiescence in an erroneous decision cannot bar the United States from collecting a tax otherwise lawfully due:[4] "the doctrine

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[2] 1944 Cum. Bull. 5.

[3] Rev. Rul. 119, 1953-2 Cum. Bull. 95; Rev. Bul. 55-136, 1955-1 Cum. Bull. 7, 213, republished as Rev. Rul. 56-299, 1956-1 1 Cum. Bull. 603.

[4] *Manhattan Co.* v. *Commissioner*, 297 U.S. 129; *Commissioner* v. *Acker*, 361 U.S. 87; *United States* v. *Calamaro*, 354 U.S. 351, 355-359; *Koshland* v. *Helvering*, 298 U.S. 441, 446-447; *Tomlinson* v. *Miles*, 316 F. 2d 710, 714 (C.A. 5), certiorari

of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law."[5]

Nor can petitioner claim to have been misled as to the effect of an acquiescence, for each Cumulative Bulletin carries a prominent warning to taxpayers that rulings and acquiescences do not have any binding effect. The 1944 Cumulative Bulletin, for example—the one in which the acquiescence in *Caulkins* was announced—stated on its front page that:

> The rulings reported in the Internal Revenue Bulletin are for the information of taxpayers and their counsel as showing the trend of official opinion in the administration of the Bureau of Internal Revenue; the rulings other than Treasury Decisions have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law which has not been formally approved and promulgated by the Secretary of the Treasury. * * *

1944 Cum. Bul., p. i. See also *e.g.*, 1952–1 Cum. Bull., p. i; 1964–1 Cum. Bull. 3. In the face of that express disclaimer, there is no basis for a claim by petitioners that they relied on the acquiescence in *Caulkins* as a

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denied, 375 U.S. 828; *Carlton's Estate* v. *Commissioner*, 298 F. 2d 415, 419 (C.A. 2); *Cahen Trust* v. *United States*, 292 F. 2d 33, 39 (C.A. 7); *Lubin* v. *Commissioner*, decided October 24, 1963 (22 T.C.M. 1494), reversed on other grounds, 335 F. 2d 209 (C.A. 2); *Schwartz* v. *Commissioner*, 40 T.C. 191. See also Lynn and Gerson, *Quasi-Estoppel and Abuse of Discretion as Applied Against the United States in Federal Tax Controversies*, 19 Tax. L. Rev. 487, 512–516 (1964); 10 Mertens, *Law of Federal Income Taxation* (Rev. 1964), Section 60.16.

[5] *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 183.

binding assurance that their hoped-for capital gains treatment would not be challenged. See *Helvering* v. *N.Y. Trust Co.,* 292 U.S. 455, 468.

Since an acquiescence does not itself have any statutorily-prescribed effect, the only way in which it can operate to relieve a taxpayer of a tax otherwise due is through the Commissioner's subsequent exercise of the power expressly given him by § 7805 of the 1954 Code (§ 3791(b) of the 1939 Code) to "prescribe the extent, if any, to which any ruling * * * shall be applied without retroactive effect." What limits, if any, there may be on the Commissioner's failure to exercise the power given him by § 7805 need not be considered in this case. Petitioners point to nothing that would distinguish this case from the revocation of any acquiescence, and their argument that it was an abuse of discretion for the Commissioner not to give the revocation only prospective effect amounts to an argument that revocations of acquiescences must always be given only prospective effect. That argument would convert the discretionary power given the Commissioner by § 7805 into a mandatory duty and thus wholly subvert the limited purpose of that provision.

2. Even if acquiescences did commit the United States to follow the decision acquiesced in, petitioners would still not be helped, for the *Caulkins* decision in no way supports the treatment claimed by them. The *Caulkins* case was analyzed in detail in our brief in *Midland-Ross* (pp. 25–31). As we there showed, the decision was based, not on a distinction between original issue discount and stated interest, but upon a reading of § 117(f) as specifically making all the pro-

ceeds of a *retirement* of certain kinds of evidences of indebtedness taxable only as capital gain whether or not some part of the proceeds constituted interest. Not only was the *Caulkins* decision on its face based specifically on § 117(f) (retirements), but in later cases the Tax Court itself[6] expressly distinguished sales and held that the portion of the proceeds of a sale attributable to original issue discount was taxable as ordinary income.[7] Since the notes in this case were sold rather than retired, neither § 117(f) nor, hence, the *Caulkins* decision has any application.

There is a further reason why *Caulkins* is even less relevant to this case than it was to *Midland-Ross*. In *Caulkins*, the taxable event was a retirement of the obligation, and in *Midland-Ross* the taxable event was treated as being the *sale* of the obligation. In this case, however, the partnership used the accrual method of accounting: what the Commissioner asserted, and both courts below held, was that the partnership was required to *accrue* the compensation for the use of its money which was earned during the year regardless of whether the note was sold (as 20 of them were) or was held beyond the end of the taxable year (as 13 of them were). The additional amount the borrowers agreed to pay on maturity of the notes was admittedly compensation for the use of petitioner's

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[6] In principle, the Commissioner's acquiescence was in the Tax Court's decision in the *Caulkins* case, not in the Sixth Circuit's decision affirming it.

[7] See *Paine* v. *Commissioner*, 23 T.C. 391, 401, reversed on other grounds, 236 F. 2d 398 (C.A. 8); *Shattuck* v. *Commissioner*, 25 T.C. 416, 423; *Stanton* v. *Commissioner*, 34 T.C. 1, 6. See, also, *Midland-Ross* Br. 29–31, n. 21.

money, and it was undeniably earned ratably over the term of the notes. Nothing more is required to establish the duty to accrue the compensation as it is earned. How the proceeds of a sale or retirement of such a note would be taxed to a cash-basis taxpayer who had not previously accrued the income is wholly beside the point.

The point just made may explain why petitioners have chosen persistently to misstate the issue in this case as being the treatment of "gain realized on the sale of notes issued at a discount" (Pet. Br. 2). As we had occasion to note in response to the same misstatement in the petition, that is not the issue. The issue is whether petitioners were required to accrue the discount as it was earned, (see §§ 41, 42(a)). The "sale or exchange" (§ 117(a)(4)) and "retirement" (§ 117(f)) provisions—and the confusion about their application created by *Caulkins*—simply have nothing whatever to do with that question.

II

THE AMOUNT PROMISED TO BE PAID ON A NOTE IN EXCESS OF THE AMOUNT FOR WHICH IT WAS ISSUED HAS HISTORICALLY BEEN TREATED AS INTEREST

The historical treatment of original-issue discount was developed in full in our brief in *Midland-Ross* (pp. 23–45) and need not be repeated here. A few additional comments are appropriate, however, to answer several specific contentions made by the petitioners in this case.

1. As noted in our *Midland-Ross* brief (pp. 34–35), the Act of June 17, 1929, 46 Stat. 19, 20, exempted

"interest" on Treasury bills from taxation and expressly provided that any discount at which such bills were issued "shall be considered to be interest" for purposes of the exemption. Petitioners quote two statements by Senators Couzens and Reed in the debates on that bill as showing a Congressional understanding that gain attributable to original-issue discount was generally treated as capital gain (Br. 14–15). When placed in their proper context, the statements do not have the significance attributed to them.

The bill initially proposed by the Treasury would have exempted not only the "interest" on Treasury bills but also "any gain from the sale or other disposition" of such bills, without distinguishing between gains attributable to the discount at which the bills were issued and gains attributable to fluctuations in their market value due to changes in the prevailing interest rate (71 Cong. Rec. 2328). Senator Couzens objected to that version of the bill specifically because it failed to make that distinction. He had no objection to the "interest" element, including discount, being exempted so that federal bonds would be exempt "to the same extent that State and municipal bonds are exempt" (p. 2329),[8] but saw no reason why a "capital gain" from such a bill (p. 2330)—which he later specifically identified as a gain attributable to market fluctuations (p. 2331)—should not be taxed. Senator Reed at first failed to recognize the distinction between the two kinds of gain, but then immedi-

[8] For the treatment of original-issue discount on State bonds as exempt "interest," see pp. 33–36 of our *Midland-Ross* brief.

ately went on—in a statement not quoted by petitioners—to acknowledge the distinction and to agree that only the "interest" element should be exempt and that "capital gains" should continue to be taxed (p. 2331).[9] In view of the agreement thus reached that only "interest" and not "capital gains" should be exempt from tax, the bill was amended to delete the proposed exemption of any "gain from the sale or other disposition" of Treasury bills and to substitute the provision ultimately adopted making explicit the treatment of original-issue discount as interest.

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[9] The position of the several Senators is made plain in the following colloquy, in which the statement of Senator Reed quoted by petitioners is italicized (71 Cong. Rec. 2331):

> Mr. WALSH of Montana. I understand that perfectly well; but if I discount a bill for $100 at the bank, and I get only $96, I am paying 4 percent interest, or substantially 4 percent; and the difference between the $96 and the $100 is interest. It can not be designated in any other way, and that is the way it is understood. So when the Treasury discounts its bills at 4 percent, that 4 percent represents the interest which the Government pays.
>
> If the interest is exempt, as provided in the bill, and the principal is exempt, as provided in the bill, if the purchaser of the bill sells it meanwhile, and makes a profit on his sale, why should not that profit be taxable just the same as the profit he makes on the sale of stocks or anything else?
>
> Mr. COUZENS. Mr. President, if the Senator will yield to me, is not this a simple illustration? If the Government sells to you a $1,000 bond or certificate of indebtedness on a 4 percent basis, and you turn around and sall it on a 3 percent basis, the difference is profit.
>
> Mr. WALSH of Montana. Unquestionably.
>
> Mr. COUZENS. That is the simple way of putting it. In other words, if the Government sells the certificate to one individual on a 4 percent basis, and he turns around and

There is nothing in that history, we submit, to support petitioners' statement that the bill was originally opposed "because the Senate was of the opinion that discount when realized is capital gain and did not wish to set any precedent which would exempt any capital gain from tax" (Br. 14). The only feature of the bill which was opposed was its failure, as originally proposed, to distinguish between "interest" in

sells it on a 3 percent or 2 percent basis, the difference is profit.

Mr. WALSH of Montana. Exactly. I want 4 percent on my money, and I buy the bill; but I find some one who is perfectly content with 2½ percent, and he will offer me a premium for it.

Mr. REED. *Mr. President, it seems to me these questions have brought the issue down to the real point. What actually happens in the case of the transaction described by the Senator from Montana is that a negotiable instrument is bought at one price, and subsequently sold at another; and the profit, taken in connection with the time the bill is held, is a capital gain which is the equivalent of interest on that money.* [Emphasis supplied.]

Mr. COUZENS. Oh, no!

Mr. REED. It is just a matter of definition. Please indulge me until I finish the thought. Now, if we can agree that the amount of the discount at which the bill was originally sold shall be considered as interest, and that shall be nontaxable, while at the same time any transactions relating in capital gains pending the maturity of the certificate should be taxed, I think we should all be agreed on the situation. All the Treasury wants is to make that which is in good faith the equivalent of interest tax free, as it is today on Treasury certificates; and I understand that the Senator has no objection to that.

Mr. WALSH of Montana. Not at all. We are agreed about what ought to be done. It is simply a question as to the language in which our views ought to be expressed.

Mr. REED. It is merely a matter of expressing that thought clearly; and we ought to be able to agree on that.

the form of discount—which everyone agreed should be exempt—and "capital gain" attributable to market fluctuations—which everyone agreed should not be exempt. The only "precedent" which the Senate did not wish to set was that of exempting market fluctuation gains; the exemption of interest in the form of discount was already well established for State bonds and the only thing the Act as finally adopted did was to extend the same rule to federal bonds. The true significance of the 1929 Act is simply that it was the first of many examples of Congress' consistent recognition—each time it has had occasion to deal expressly with the question—that original-issue discount is interest and should be treated as such for tax purposes.

2. At pages 15–16 of their brief, petitioners quote at length from a 1938 report of a subcommittee of the Committee on Ways and Means in connection with a proposal (to eliminate the tax on capital gains) on which no further action was ever taken. From the very portion quoted, it is evident that the report was speaking only of *market* discount, which has indeed generally been treated as giving rise only to capital gains (see pp. 18–20 of our brief in *Midland-Ross*).

3. Petitioners list five provisions of the 1939 Code that allegedly would have been unnecessary if original-issue discount were generally treated as interest (Br. 17). The first three (§§ 117(a)(1)(D), 42(b), and 42(c)) were considered in our *Midland-Ross* brief (pp. 40–43) and, as there shown, their addition proves just the opposite. The remaining two, §§ 201(e) and 207(d), added by the Revenue Act of 1942,[10] require

[10] §§ 163 and 165, 56 Stat. 798.

life insurance companies and certain mutual insurance companies to accrue bond discount and to amortize bond premiums. Those provisions, it may be seen, served two very substantial purposes entirely apart from any question of the status of original-issue discount as interest: (1) they required such companies to treat *market* discounts or premiums as giving rise to ordinary income or deductions;[11] and (2) they required such items to be accounted for by accrual notwithstanding that life insurance companies were at the time generally required to report their income on the cash basis.[12]

4. Petitioners' reliance on the treatment of bond *premiums* (Br. 21–23) is equally misplaced. Most of the litigation over the treatment of bond premiums, and the statutory solution ultimately adopted, was concerned primarily with the treatment of bonds purchased on the market at a premium,[13] which poses a question analogous to the treatment of market discount rather than of original-issue discount.

The only case cited by petitioners which directly involved the treatment of bonds originally issued at a

[11] See Treas. Regs. 111 (1939 Code), §§ 29.201–9, 29.207–6. The requirement that *market* discount be accrued by such companies was eliminated by the Revenue Act of 1964, § 228, 78 Stat. 19 (amending §§ 818(b) and 822(d)(2) of the 1954 Code). The purpose was to put such companies back on a par with other corporations in that respect, accounting for market discount as capital gain and for original-issue discount as ordinary income. See S. Rep. No. 830, 88th Cong., 2d Sess., pp. 122–124.

[12] See *Massachusetts Mutual Life Ins. Co.* v. *United States*, 288 U.S. 269; S. Rep. No. 1631, 77th Cong., 2d Sess., p. 147.

[13] See, *e.g.*, *New York Life Ins. Co.* v. *Edwards*, 271 U.S. 109 (Pet. Br. 21).

premium is *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552. The question there was whether a premium received by a corporation on the issuance of bonds prior to 1913 had to be reflected in its tax returns for subsequent years, either (a) under regulations characterizing such premium as income and requiring it to be amortized over the life of the bonds, or (b) as an offset to the stipulated interest paid to the bondholders and claimed by the corporation as a deduction. With respect to (a), the Court held that since the premium was received prior to the adoption of the Sixteenth Amendment, it could not be taxed as income in later years notwithstanding the amortization requirement—a requirement which the Court noted, however, "may properly be applied to premiums paid subsequent to March 1, 1913" (284 U.S. at 558).[14] As to (b), the Court held that the issuer could deduct the "nominal" interest payments in full even though economically they represented, in part, a repayment of the amount received for the bonds rather than compensation for the use of the lenders' money. The significance of the latter holding is questionable in view of the Court's explicit recognition that bond premiums received after 1913 must be amortized as income, since the effect of such treatment is precisely the same as if a pro rata share of the premium were subtracted from the "nominal" yearly interest

[14] The regulation has in fact been so applied. See, *e.g.*, *Bayshore Gardens, Inc.* v. *Commissioner*, 267 F. 2d 55 (C.A. 2); Treasury Regulations 111 (1939 Code), § 29.22(a)-17(2)(a); Treasury Regulations on Income Tax (1954 Code), § 1.161-12(c)(2) and (5).

in order to arrive at the true or "effective" interest. But even if the Court's rejection of the "effective interest" approach is taken at face value, it has little bearing on the present case. For, whatever the merits of that ruling, it soon became clear that its principle was limited to the treatment of premiums and was not to be extended to the treatment of discounts: in the case of bonds issued at a discount, the Court had no hesitation in holding that the issuer could deduct not only the "nominal" interest but also an amortized part of the amount to be paid on maturity in excess of the amount borrowed. *Helvering* v. *Union Pacific Co.*, 293 U.S. 282; *Old Mission Co.* v. *Helvering*, 293 U.S. 289; *Great Western Power Co.* v. *Commissioner*, 297 U.S. 543; *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. 2d 695 (C.A. 4); *American Smelting & Refining Co.* v. *United States*, 130 F. 2d 883, 885 (C.A. 3). And if discount and premium are distinguishable for purposes of the issuer's accounting, they are equally distinguishable for purposes of the lender's accounting.

CONCLUSION

For the reasons stated above and in our brief in the companion case, *United States v. Midland-Ross Corp.*, No. 628, the judgment below should be affirmed.

Respectfully submitted.

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